

## Guarantee Funds for SME Loans

### Summary

This paper deals with the establishment of guarantee funds for loans to SMEs, intended as a tool for improving their access to capital. Because the main obstacle for proper access to capital is that the SMEs lack the collateral, which banks require, guarantee funds could be useful to mitigate this problem, but only as a supplementary tool among others. The main objective of guarantee funds should be to develop small businesses, but at the same time these funds should not be externally subsidized, i.e. they need to be self-sufficient. To achieve these objectives there should be two founding agencies for these funds: the government and commercial banks, with the government holding a controlling share in the fund's capital. The central government (together with NBB) should institute the necessary regulations and originate the guarantee funds. However, local governments could also establish such funds and manage them. To function effectively the funds must observe certain safety requirements, such as: covering only a part of each risk, observing limitations on the amount granted for any one particular risk, limiting the multiplication factor for the guarantee capital, and limiting the exchange rate risk. Furthermore, to operate in a safe and profitable manner, guarantee funds should have a possibility of using the right of regress.

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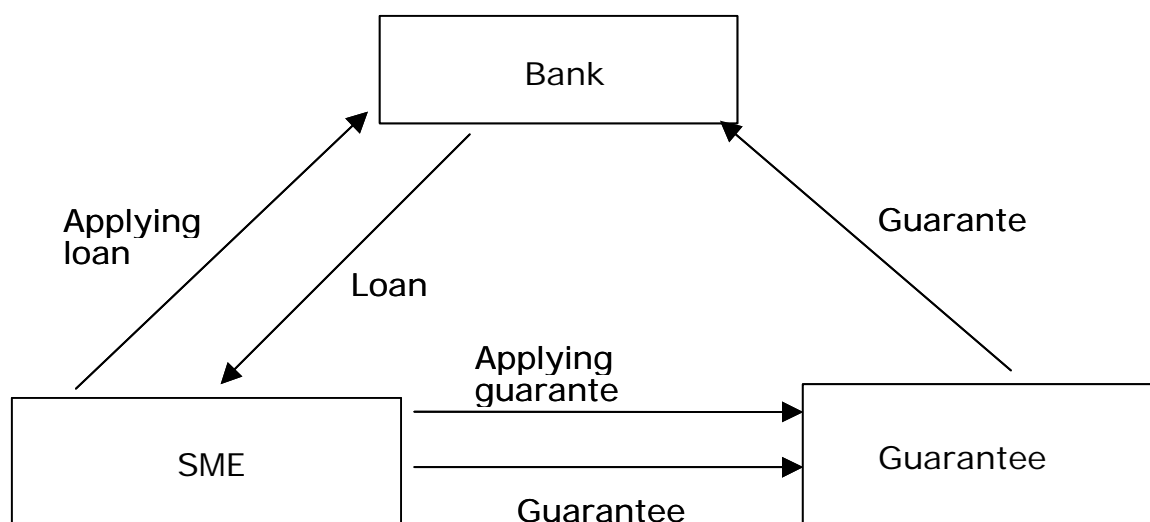
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## 1. Introduction

The contribution of small and medium enterprises (SME) to the Belarusian GDP is not as big as in other transition countries<sup>1</sup>. The lack of access to financial resources is a severe problem for SMEs. The main obstacle is the inability of the SMEs to provide the collateral, which is an essential requirement for banks. There are several possible approaches to overcome this problem and to facilitate access to financial resources for small businesses. Establishing special micro-finance institutions that can realize particular techniques when granting loans to SMEs is the first step to be implemented<sup>2</sup>. Secondly, the mortgage lending legislation should be improved<sup>3</sup> in order to enable individual entrepreneurs to use their real estate holdings as collateral. At present, banks refuse to accept such collateral as a rule, because of problems related to claiming this collateral in case of the debtor's default. The two above-mentioned instruments are extremely important for improving small business access to credit resources, however there are also a number of other tools. In particular, sureties or guarantees by third entities to banks or other financial institutions that grant loans to small businesses can partially substitute for the banks' collateral requirements.

International experience has shown that establishing special guarantee funds for SME loans can substantially improve the situation for small business. In brief, the mechanism of how the guarantee fund operates looks like this (see Chart 1):

**Chart 1. The loan procedure mechanism of a guarantee fund**



1. An SME applies to a bank for a loan with a proposed collateral.
2. The bank evaluates the application and decides that a loan could be granted under certain collateral conditions, or if the balance of the collateral is provided by a guarantee fund.
3. The SME applies to the guarantee fund for a guarantee, submitting documents confirming the bank's intention to grant the loan, as well as any other documents required by the guarantee fund.
4. The guarantee fund evaluates the application and decides to grant a guarantee.

<sup>1</sup> In 2003 the share of small enterprises in the Belarusian GDP was 8.2%. Because of different ways of defining small and medium enterprises in different countries it is more correct to compare the share of the private sectors (which are mainly represented by SMEs) in the GDPs of different countries. In 2002 the shares of the private sector in the GDPs were: Belarus – 25%, Czech Republic – 80%, Estonia – 80%, Hungary – 80%, Lithuania – 75%, Poland – 75%.

<sup>2</sup> For relevant information see GET-IPM PP/12/04 "Proposals for the development of micro-finance institutions in Belarus".

<sup>3</sup> For relevant information see GET-IPM PP/07/03 "Recommendations for improving the effectiveness of mortgage banking in Belarus – the refinance side".

5. The SME makes a payment to the guarantee fund for the guarantee granted.
6. The bank and the guarantee fund conclude a guarantee agreement.
7. The bank and the SME conclude a loan agreement.

Taking into account that this tool should be accompanied by the other ones mentioned, this paper proposes that guarantee funds be established in Belarus. Guarantee funds for SME loans are usually considered to be non-commercial organizations. The primary goal of guarantee funds is to facilitate the development of small business. However, they are not public donor organizations, on the contrary they should be market oriented and must not become loss making. Their main advantage is to gather together all agents that are interested in the development of small business for the purpose of granting so-called consolidated guarantees.

In this paper we focus on the most urgent questions that need to be answered in order to establish effective and solvent guarantee funds in Belarus. The paper is structured as follows: In Section 2 we consider the mechanisms of forming guarantee capital for the funds and identify those agents that could provide resources for the fund. In Section 3 we deal with organizational issues applying to guarantee funds: how they should be managed and supervised. In Section 4 we focus on various aspects concerning the economic activities of the funds and the regulations needed to make them solid and credible.

## **2. Ownership and capital structures of guarantee funds**

### *2.1. Ownership of guarantee funds*

From a bank's point of view it doesn't matter what kind of collateral will be provided only the following aspects do matter: value, liquidity, safety, explicitness and irrevocability. In order for a bank to be ready to accept a fund's guarantee, it must at least be explicit, i.e. there should be a clear source for discharging the obligation given by the fund. Thus a successful guarantee fund should possess a definite amount of financial resources to underlie the guarantees given. These financial resources are at the core of a guarantee fund's activity, and are called the guarantee capital.

Thus the first consideration when establishing guarantee funds in Belarus must be the question of accumulating sufficient resources for the guarantee capital<sup>4</sup>. All the agents that are interested in a well functioning guarantee fund institution should be encouraged to contribute to this capital. International experience shows that the following agents usually provide resources for guarantee capital: central and local governments, commercial banks and external donor organizations. The specific combinations of these agents varies widely, being dependent on the country and reflecting its economic peculiarities and its government's vision of the guarantee funds' roles (see Box 1<sup>5</sup>).

It goes without saying that the government should be the main agent to put up the guarantee capital, because of its interest in developing small businesses in order that they may significantly increase their contributions to the gross income of the country. Moreover, only governments can afford to invest funds with the intention of not generating returns over long periods of time, which is a condition for meeting the strategic goals of guarantee funds, i.e. the long-term development of small business. For instance in Lithuania the government alone undertook all the responsibilities without attracting other market agents. Nonetheless, a guarantee fund is normally a non-commercial organization, which also needs to be self-sufficient. A government

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<sup>4</sup> Questions about the volume of the guarantee capital needed in Belarus, the specific agents involved and the proportions of their investments in the guarantee capital will be considered in a later paper on guarantee funds.

<sup>5</sup> Guarantee funds exist in most developed and transitions countries. We focused on transition countries with rather successful guarantee funds, as their experience is more salient to Belarus.

may feel it to be difficult to single handedly free up the financial resources required to form the guarantee capital needed, which would satisfy all the demands for guarantees. For this reason, commercial agents that may show an interest in creating guarantee funds should be encouraged to join in and to provide a part of the guarantee capital.

### **Box 1. Ownership structure of Guarantee Funds in selected countries**

**Estonia:** The Estonian Credit and Export Guarantee Fund "KredEx" is a self-sustaining fund under the jurisdiction of the Ministry of Economic Affairs and Communications, whose goal is to support the development of enterprises, exports and housing. KredEx was established by the Ministry of Economic Affairs in July 2000 who also put up the guarantee capital.

**Hungary:** There are 8 regional guarantee funds in Hungary, but 90% of the guarantees are granted by Hitelgarancia. It was established in 1992 by the Hungarian state and by the Hungarian commercial banks as a well-capitalized company in order to support the access of domestic small- and medium sized enterprises (SMEs) to loans and bank guarantees by means of granting them unconditional payment guarantees (sureties). The main owner of the fund is the Hungarian government that owns a bit more than 50% of the fund's assets and contributed a corresponding share to the guarantee capital. Commercial banks and other financial institutions that have put up the remainder of the guarantee capital own about 49%.

**Lithuania:** The Agricultural Fund for Credit Guarantees was created in 1997 as a joint-stock company. The fund deals with granting guarantees to banks and with repayments of middle and long-term problem loans that have been granted to agricultural enterprises. The Ministry of Agriculture is the only founder of the fund and the only owner of the guarantee capital of the fund. According to Lithuanian legislation the state accepts subsidiary responsibility on claims to the fund.

**Poland:** There exists a range of guarantee funds for SMEs in Poland; the majority of them were established via technical assistance programs. A Polish-British program for small business development established two regional funds and their guarantee capitals. In the mid-90s a number of funds and their guarantee capitals were created by various European agencies promoted by the Polish Foundation for SME Promotion and Support. Other funds were established by the State Treasury Agency for Agricultural Ownership. Yet another regional fund was established in Poznan in 2000, based on local resources (25%) and the Polish Saving Bank (75%).

### *2.2. Incentives for commercial banks to participate in guarantee funds*

A generally applicable incentive for banks to invest their funds in guarantee capital is the possibility to generate additional profit from this participation, and this for two main reasons. The first is connected with the penetration of new market segments and the second one with additional sources of relatively cheap liabilities.

From a bank's point of view to penetrate the segment of small and medium enterprises - regardless of their branch affiliations - is rather attractive once the credit risk has been reduced, i.e. once adequate collateral has been provided. First, for all groups of banks this market segment can provide increased income, since small enterprises are often more profitable than other sectors of the economy<sup>6</sup> and hence are often ready to pay higher interest rates (see Table 1).

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<sup>6</sup> In 2003 the profitability of small enterprises (without individual entrepreneurs) was 11.1%, while the average profitability of total real sector was 9.1%.

**Table 1. Cost of borrowing for different groups of creditors**

	Legal entities	Individual entrepreneurs	Physical persons
Loans in national currency	26.2	29.1	26.5
Loans in hard currency	10.4	11.0	9.7

*Note:* Average interest rates on new loans granted by Belarusian banks during the 1<sup>st</sup> half of 2004 (with maturities of less than 1 year).

*Source:* National Bank of Belarus.

The higher interest rates reflect in part the higher risks that individual entrepreneurs represent; nevertheless interest rates for this segment of the market will remain high relative to other market segments even after reducing the banks' risks through improved guarantees. Thus, the possibility of receiving higher interest income under conditions of acceptable risk is an advantage that will stimulate any bank to participate in the mechanism of consolidated guarantees.

For the group of small and medium sized banks to penetrate this segment is more than only a possibility to increase profits. For them granting loans to SMEs may become their core lending strategy, which will allow them to find a stable and fairly profitable field for lending<sup>7</sup>. At the same time it will enable them to extend their limits beyond niche strategies, which are very risky and require operations at a big scale in order to be profitable. In sum, this group of the Belarusian banks should be very interested to invest in guarantee funds, which will allow them to find stable and competitive advantages in the Belarusian lending market.

The second main incentive for banks to participate in the guarantee funds mechanism is connected with the possibility of obtaining additional liabilities. But the guarantee fund mechanism foresees placing its resources in the bank's deposits. The amount of these deposits is usually related to the bank's share in the guarantee capital and the volume of loans granted under guarantees. Thus the initial outflow of liquidity (bank investments) will be compensated for by the inflow of guarantee fund's deposits. Moreover there will be a chance for the banks to obtain additional funds beyond what they invested in the guarantee capital, since the government invests in the capital as well.

Certainly, there should be no compulsion forcing banks to provide guarantee capital. If coercion were used, the banks would be unlikely to realize the benefits they desire. Compulsion would only lead to distortions at the market from the point of view of funds allocation. In other words, the banks should be attracted to participate in creating guarantee funds by creating conditions under which they can realize the potential benefits they are seeking.

International experience (especially the Hungarian experience where the role of banks is particularly strong) shows that the first potential benefit can be realized mainly through judicial measures. The law (either state law or the statutes of the guarantee funds) should require that loan guarantees can only be granted to those banks that have an explicit share in the guarantee capital. For instance the Hungarian Hitelgarancia is only allowed to grant loan guarantees to financial institutions or specialized financial institutions possessing a nominal stake of at least HUF 10 m<sup>8</sup> in Hitelgarancia (0.2% of the registered capital), or to co-operative financial institutions with a nominal stake of at least HUF 1 m in Hitelgarancia (0.02% of the registered capital). The second potential benefit is usually realized through additional agreements between each bank and the guarantee fund. These agreements may

<sup>7</sup> The share of loans to individual entrepreneurs during the 1<sup>st</sup> half of 2004 amounted to only 0.5% of all totally new granted loans (this figure could be a little bit higher because of small enterprises, but needed statistical data is lacking), while the share of small business in the Belarusian GDP is more than 8%. Furthermore according to an IPM poll of small enterprises only about 50% of them use borrowed funds, and only 45% of those that do resort to bank loans.

<sup>8</sup> About USD 50,000.

include the following aspects: minimum level of guarantee fund deposits in any given bank, which is related to the sum of guarantees granted to this bank by the fund; the maturity of these deposits and the interest rates paid by the bank on them; the mechanisms for honoring guarantees on non-repaid loans, etc. Being a contributor to the guarantee capital gives a bank the opportunity to negotiate these types of conditions. Thus, the guarantee fund will try to conclude agreements on favorable conditions and without discrimination with all banks that are contributors to the guarantee capital. On the other hand, banks must have the right to quit participating in the guarantee fund and having their contribution to the guarantee capital fully reimbursed. Because of the penury of capital in Belarus, many of these principles should be anchored in law, for instance the ratio of the guarantee fund's deposit in a given bank to the size of its share in the guarantee capital, as well as some other norms to insure an efficient operation of the fund. Thus, conditions need be created to attract banks to contribute to the guarantee capital. The measures for realizing both possible conditions may be summarized as follows:

*A. The law (either state law or the guarantee fund statutes) must stipulate that only banks that own an explicit part of the guarantee capital can be granted guarantees by the fund. This should be the main criterion for allocating guarantees; and there should certainly not be any government pressure brought to bear. In our opinion the value of a bank's share in the fund's guarantee capital should range between 0.5% and 5%, depending on the volume of the bank's assets and its share in total loans to SMEs. Also a ratio should be defined between a bank's share in the guarantee capital and the maximum total guarantees granted to that bank.*

*B.1 The guarantee fund statutes should include a clause allowing banks and the fund to freely conclude mutually beneficial agreements.*

*B.2 The law should stipulate that a guarantee fund must deposit a certain sum in each bank, which is related to the bank's share in the guarantee capital and to the total sum of the guarantees granted to this bank.*

*B.3 The law should also stipulate a range of norms to insure reliability of the fund's activities.*

*B.4 Banks must have the right to withdraw from the guarantee capital with full reimbursement of their investments.*

### *2.3. Capital structure of guarantee funds*

The possible involvement of both government and banks in a guarantee fund raises the question about how they should share in the guarantee capital. International experience shows that in all countries the government plays a leading role in order to be able to insure that its long-term economic goals are upheld. At the same time the Hungarian experience shows that the approach of the government and the banks contributing approximately equal shares (about 50/50), but with control remaining in the government's hand, is very effective. On the one hand it allows the government to pursue its long-term goal of SME sector development, on the other hand it leads to self-sufficiency by the guarantee fund without excessive expenditures by the state. The Hungarian experience suggests that an equity structure of the guarantee fund could be used in Belarus too. In our opinion the government should own a controlling share of the equity, to insure that its prime objective of small business development is kept in sight, rather than that of generating profits. At the same time, the banks and other financial institutions should contribute nearly 50%, since the Guarantee Fund should be a self-sufficient organization, which meets the banks' needs.

The current legislation and the government regulation "On the order of granting sureties to small business entities by non-commercial organizations" do not allow for the participation of banks. The existing legislation should either be substantially amended, or a new law "On guarantee funds for SMEs" should be enacted to include

all the issues raised above, with a view to insuring a successful functioning of the consolidated guarantees mechanism.

### **3. Organization and governance of guarantee funds**

#### *3.1. Internal governance of guarantee funds*

The efficient functioning of a guarantee fund will to a great extent depend on its internal management, and on external regulation and supervision as well. As for the internal governance of the fund, foreign experience demonstrates much commonality in the approaches to the management of guarantee funds. As a rule, guarantee funds for SMEs are non-commercial organizations and legal entities<sup>9</sup> in all countries. At the same time guarantee funds have different organizational forms: joint-stock companies, funds, limited liability companies, etc. But this variety of organizational forms does not affect the principles of internal guarantee fund management. For the great majority the management structure includes three main bodies: supreme board, executive body and the board of experts. The supreme board usually deals with developing strategies for the company, holding elections, appointing or approving the executive body, control of the executive body's activities, appointment of the chief accountant, personnel policy, etc. The executive body manages the day-to-day activities of the guarantee fund, makes proposals for future development, works out the mechanism for granting guarantees (sureties), enters into agreements with partnership banks, decides on granting or rejecting guarantees, etc. The board of experts is a body of specialists who considers and analyzes the documents submitted by SMEs when applying for guarantees. After analysis of the documents the board makes a recommendation on whether a guarantee should be granted or not and forwards it to the executive body who takes the final decision. Usually the board of experts includes representatives of the local authorities and the lending banks, which helps it to pursue the long-term goals and the objective of self-sufficiency.

#### *3.2. Regulation and supervision of guarantee fund activities*

The principles of internal management are rather similar in all countries, while there are different approaches concerning the internal regulations and supervision. If a guarantee fund is wholly government-owned, regulation and supervision present few problems. In this case the government - as the main and only owner of the fund - can establish the necessary regulations and adopt them to the activities of the guarantee fund. There will be no contradictions between the goal of small business development and profitability: the first one will be the only priority. But this approach will, on the one hand, require the government to input very large financial resources, and on the other hand, the guarantee fund will not be seen as quite so reliable by the banks.

In the case where both government and banks (or intermediary agencies) cooperate, and where the government wants to minimize its financial investment, the norms or regulations and the prudential control become much more important. Firstly, they are needed to co-ordinate the different objectives of the participants. Secondly and thirdly, they are needed for maintaining the safety and stability of the guarantee fund and avoiding any moral hazards. Hence, the bodies to be responsible for external regulation and supervision need to be determined. The regulations should be worked out by the government, based on incentives for SME development and self-sufficiency. On the other hand, the process of granting guarantees for SME loans has an influence on the banking sector as well. It seems reasonable to assume that the government regulations will tend to be rather soft, leading to the possibility of deteriorating the banks' credit portfolios. Realizing this, we propose that the National Bank of Belarus (NBB) become a partner in the regulatory body. This step would likely strengthen the

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<sup>9</sup> Some organizations, for instance in Poland, function as departments within larger legal entities, but this does not change the general tendency.

regulatory measures, making the guarantee funds more solid and reliable. Concerning the supervision function, the government aims mainly at SME development, but the supervisory body must also aim at sustaining the funds' stability. Hence, we propose that the guarantee funds should be supervised by the NBB.

### *3.3. Distribution of labor between the central and local governments concerning guarantee funds*

In regard to the management and regulation of the guarantee funds, one other issue needs to be looked at. In general, the government accomplishes its managing function by participating in the ruling bodies and fulfilling its regulatory function. But when looking at the different levels of government (central and local), an optimal allocation of responsibilities between them needs to be found. There are three possibilities: In the first, only the central government enacts the regulations, while the local governments execute them, i.e. they establish the guarantee funds and manage them through their representatives. Under the second approach, the central government alone executes both the regulatory and management functions, and establishes the guarantee funds. The third is a combined approach whereby the central government executes both regulatory and managing functions. It can participate in establishing guarantee funds itself, but local governments can manage and establish regional guarantee funds as well.

There are a number of arguments pro and con concerning the first and second approaches. Handing the managing functions to local governments (first approach) can lead to increased total operational costs, since there will be many regional funds with limited guarantee capitals. On other hand, these funds may also reduce costs because they do have better knowledge about the specifics of the regions. Moreover, a larger number of guarantee funds across the country may stimulate competition among them for the same clients. The first approach is more effective in big countries (federations) that consist of a range of economically different regions, while the second one is more expedient for small countries with rather similar economic conditions in the different regions. The third approach combines the advantages and disadvantages of both methods. Concerning Belarus, we suggest that the third approach would present the best solution. This approach has demonstrated its effectiveness in Hungary whose economy has some features similar to the Belarusian one. Despite the fact that the majority of guarantees are concentrated in the centralized Hitelgarancia (about 90%), the small regional guarantee funds also work effectively. Due to this scheme of capacity distribution the share of guaranteed loans as a percentage of all loans granted was about 2.1% by the end of 2003 (for Hitelgarancia this indicator amounted to about 1.9%)<sup>10</sup>. We believe that using the third approach best suits the situation in Belarus, where both kinds of funds will be able to realize their advantages.

## **4. Towards a solid and credible guarantee fund**

### *4.1. Procedures for granting a guaranteed loan*

When a potential borrower applies for a loan, the bank tries to assess his creditworthiness, or in other words, the bank assesses the credit risk of the potential loan. To do this, banks consider a number of factors. There are different systems of creditworthiness assessment used in different countries. But almost every system includes the following factors: the macroeconomic environment, the financial performance of the potential borrower, the quality his management, his credit history, the quality of the collateral provided, personal factors, etc. Research was carried out

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<sup>10</sup> The volume of guarantees granted by Hitelgarancia by the end of 2003 was EUR 434.4 m for a loans-in-total aggregate of EUR 575.8 m.



in 2000 to reveal the relative importance given to different credit risk factors in Belarus<sup>11</sup>. The results are shown in Table 2.

**Table 2. Factors that influence credit risk evaluations in Belarus**

Factor	Factor's significance, %	
	Legal entities	Physical persons
Macroeconomic environment	23.8	18.6
Borrower's microeconomic stance	18.6	18.9
Quality of management	16.3	n/a
Credit history	7.4	11.7
Quality of the collateral provided	6.6	4.3
Changes in borrower's social position	n/a	6.4
Changes in credit contract	11.7	17.5
Personal factors	15.6	22.6

Source: Kabushkin "Managing banking credit risk".

When trying to assess the applications of small businesses, evaluating the majority of these factors would be a) too expensive relative to the size of the loan, and b) would be rather difficult for the banks because they do not possess the specialized know-how required for assessing the credit risks of SMEs. In these cases the banks usually increase the collateral requirements substantially beyond those for other borrowers to try to hedge the credit risk factors (see Table 2). More often than not, a potential borrower cannot satisfy the collateral demands and the process of granting a loan comes to a halt at this stage, *ceteris paribus*. When a guarantee fund enters this market, the situation changes. The banks do not care who provides the collateral and what type of collateral is offered, *ceteris paribus*.

#### 4.2. Guarantee to loan ratio

In an economic sense the scheme including guarantee fund means risk splitting, i.e. the bank shifts a part of the risk over to the guarantee fund. But that does not mean that the fund is willing to assume high risks, while the bank is not. Moreover, it does not mean that the fund will approve all the applications; rather the guarantee fund will assess each credit risk and will reject to grant guarantees for unacceptably high credit risks. The willingness of the guarantee fund to assume those risks that cannot be dealt with by the banks alone is based on a) its non-commercial activity, and b) on its ability to provide better risk management than the bank in specific fields. Furthermore, the guarantee fund should not assume the entire risk - the borrower must always provide a part of the collateral to the bank. In different countries the maximum allowable guarantee (to be given by a guarantee fund) to loan ratio varies widely (see Table 3).

**Table 3. Guarantee to loan ratio and requirements to collateral in foreign countries**

Country	Guarantee to loan ratio
Estonia	90% for all loans in 2003 (70% before 2003)
Hungary	60% for agricultural enterprises; 90% for loans less than HUF 10 m (about USD 50 th); 80% for all other loans (the loan figure includes principal, interest payments and commissions)
Lithuania	70% for all loans and the requirement for the borrower to invest a minimum of 10% of his own funds in the investment project
Romania	70% for all loans

Source: Istomina L., Kalmykova M., Ovseyko S. International experience of the establishment and activity of guarantee funds.

In Belarus according to the Regulation "On the order of granting..." the maximum allowable surety is limited to 70%. Generally this ratio should be correlated with the overall assessment of credit risks within the macroeconomic environment in which the

<sup>11</sup> The research of the factors that determine credit risks for Belarusian banks was carried out in 2000. It was carried out by means of questioning the credit department specialists of the largest Belarusian banks. The object of the research was banks whose shares in total loans were about 35% at that time. Participants were asked to assess the significance of the factors using a 200 points system.

economy exists. On this basis, we believe that the figure of 70% should remain the maximum limit for all loans, but some lower figure should apply for specific branches of the economy where the risks are higher. For instance the maximum value of this ratio for agricultural enterprises - in our opinion - should not be more than 50%<sup>12</sup>. Moreover, there should be a limit for the total of all risks taken vis-à-vis any one borrower. The Regulation "On the order of granting..." sets such a limit at 30% of all funds directed towards sureties. But the organizations mentioned in this regulation are not assumed to deal only with granting sureties – their fields of activities could be much broader. Concerning guarantee funds, granting guarantees should be their core activity, and the total size of all risks should be related to the total guarantee capital in the fund. For this reason we believe that a value of 30% is too high. Firstly, it could be rather risky for a fund to guarantee 30% of its capital for one particular loan. Thus, for instance, banking regulations limit this coefficient to 20% in first two years of a bank's operations and to 25% thereafter. Secondly, while these guarantee funds are primarily directed to serve small firms, we believe that the maximum of risk for any one loan should not exceed 20% to insure an effective fund operation.

#### *4.3. Guarantee to capital ratio*

To be effective the activities of guarantee funds should cover a large cross-section of small enterprises. But it would require huge financial resources of guarantee capital if the total of the sums of all granted guarantees had to be reserved. However, most loans will eventually be repaid without recourse to the guarantees granted. This gives guarantee funds the opportunity to grant guarantees on a total sum greater than that represented by the guarantee capital, i.e. the multiplicative principle is valid for the guarantee capitals in the funds. But in order to assure the funds' solidity and credibility the multiplication factor should not be too large. Here are the values for the guarantee to capital ratio used by some countries (see Table 4).

**Table 4. Relationships between guarantees and capital in foreign countries<sup>13</sup>**

Country	Guarantee to capital ratio
Hungary (Hitelgarancia)	6.1
Poland (total for all guarantee funds)	1.8
Estonia (Kredex)	3.2

*Source:* The author's calculations are based on the funds' balance sheets and on data provided by the Polish Association of Guarantee Funds.

We believe that the Belarusian legislation should include a guarantee to capital ratio limit to insure that the guarantee funds activities will be credible and reliable. Initially the maximum ratio should be limited to a safe value of about 2 to 2.5, which will not expose the funds to excessive risks. Later on the funds should examine what value of this coefficient would be acceptable for safe operation under Belarusian conditions. Thus, once the funds show positive results and gain experience with risk management this coefficient could be increased, or the limitation could even be completely eliminated.

#### *4.4. Management of the exchange rate risk*

Another type of risk exposure is associated with exchange rates. At present, the Belarusian banks grant loans in national and in hard currency in approximately equal proportions (55% and 45% of total bank claims respectively). The NBB's policies tend to encourage a rather high demand for loans in foreign currency. Therefore a guarantee fund could be asked to guarantee loans in foreign currencies, while its assets would only be in national currency. In this situation the funds will be exposed

<sup>12</sup> For relevant information see GET-IPM PP/9/04 "Measures to improve the access of agricultural enterprises to capital".

<sup>13</sup> For Hungary and Estonia the data is given as of 31.12.2003, for Poland as of 31.12.2002.

to an exchange rate risk in addition to the credit risk. In order to minimize this problem we propose that the regulations should prescribe limits for this risk as well. The present Belarusian banking legislation limits the exchange rate risk by limiting the open currency position<sup>14</sup> to 20% of the equity capital on all foreign currencies and to 10% on any one particular currency. For guarantee funds this open currency position should be interpreted as the relationship between assets and liabilities in foreign currency not only on balance accounts, but on off-balance accounts (granted guarantees) in foreign currencies as well. In order to make the operations of the guarantee funds less risky we propose to limit their gross open currency position on all foreign currencies to 10% of the guarantee capital and to 5% on any one particular foreign currency.

#### 4.5. Investment guidelines

In order that guarantee funds remain credible their assets should be invested in a safe manner. International experience shows that a bigger part of most guarantee fund assets is placed in deposits of banks whose loans are guaranteed, which makes these guarantees paid and irrevocable. For instance, 74.7% of the Estonian Kredex' assets are placed in bank deposits. At the same time the total amount of the guarantee funds assets to be placed in bank deposits should be defined through agreements between the banks and the guarantee funds. However, even after placing these funds the guarantee funds will still have some financial resources to be placed. For instance, the main assets of the Hungarian Hitelgarancia are bonds. We therefore believe that the new legislation to be enacted should include directions about where guarantee fund resources may be deposited. Only very safe instruments such as government bonds, and deposits or bonds of first-rate borrowers should be permitted.

Finally, the credibility of the guarantee funds will depend on how the legislation will define their obligations. The present Belarusian legislation defines three types of guarantee obligations: sureties, guarantees and banking guarantees. The main characteristics of these different types of obligations are given in Table 5.

**Table 5. Comparative characteristics of different types of obligations under Belarusian legislation**

	Surety	Guarantee	Banking guarantee
Responsibility	Joint	Subsidiary	Subsidiary
Dependent/independent <sup>15</sup>	Dependent	Dependent	Independent
Right of regress	Yes	No	No

In our opinion the obligations granted by the guarantee funds should have similar qualities as do banking guarantees<sup>16</sup>. First, the guarantor should be subsidiarily responsible and a guarantee should only be executed if a borrower defaults, i.e. it should be a guarantee, not a surety. Otherwise the guarantee fund could be exposed to additional risks and become hostage to moral hazards. Moreover to reinforce the credibility of guarantee funds, any guarantee granted should be independent like a banking guarantee in our opinion; the mechanism of placing deposits only at those banks that grant loans will strengthen this mechanism making guarantees collateralized and irrevocable.

<sup>14</sup> The currency position of a bank is the amount of exchange rate risk that is reflected in the relationship between claims and liabilities in foreign currency. The term 'open currency position' means that the claims and the liabilities in foreign currencies are not equal.

<sup>15</sup> This means that the guarantor has a right to negotiate the execution of his obligations (dependent) or else that he must execute them upon first demand.

<sup>16</sup> The guarantees granted may not be banking guarantees, as only banks can grant such guarantees. But the guarantees granted should have a range of features peculiar to banking guarantees in order to make these guarantees more credible for banks as lenders.

Furthermore, the question of whether a guarantor should have a right of regress needs to be defined. Right of regress means that if a borrower has not repaid his loan and the guarantee fund has executed its obligations to the bank, the claim on the borrower will then shift to the fund, rather than remain with the bank. On the one hand, if there is no right of regress<sup>17</sup> then the bank will have to deal with borrower concerning the loan repayment. Under current Belarusian conditions banks are certainly the agents that have the best chances to succeed with loan repayments, since the current legislation gives banks only the right to make claims on a borrower's assets without a court mandate. On the other hand, the bank's incentive for claiming the loan back from the borrower is not very pronounced, since it has already been reimbursed by the guarantee fund. This could lead to significant fund losses and to possible fraud by the borrowers. Furthermore, a right of regress may give a fund the possibility to obtain additional income when dealing with factoring operations. Thus both approaches have their pros and cons. Therefore we propose that every guarantee fund should assess by itself what would be more beneficial for in any given case: having this right of regress or not. We believe that there should not be an unconditional absence of the right of regress, rather it should be optional. Usually there should be a presumption of the regress right, but the fund should have the option to change it for any given contract.

## **5. Summary of recommendations**

In order to improve the access of SMEs to financial resources we think that the following measures should be implemented:

1. The policy concerning microfinancing should not be based only on the mechanism of guarantee funds. Guarantee funds should only be one tool among other essential tools such as the establishment of microfinance institutions and development of mortgage lending.
2. The ratio between the state's and the banks' capitals in the guarantee capital should be about 50/50, but the state should have a little more than 50% in order to have a controlling share.
3. The central government should implement the regulations and execute the managing functions, have a right to participate in the establishment of the guarantee funds, but local governments should have the right to manage and establish regional guarantee funds too.
4. The guarantee funds should meet the following safety criteria: the funds should cover no more than 70% of loan the volume; the maximum value of risk for any one particular borrower should be 20% of the guarantee capital; the multiplication factor for the guarantee capital should not exceed 2.5; the gross open currency position should be not more than 10% of the guarantee capital, while not exceeding 5% for any one currency.
5. Besides placing funds in bank deposits that grant guaranteed loans, guarantee funds should be allowed to place their funds in other resources too, but only with first-class borrowers or in government bonds.
6. The guarantee funds should grant guarantees (subsidiary responsibility), but not sureties. To avoiding the danger of losses, any guarantee fund should have an optional right of regress, i.e. it should have the possibility to use it or not.

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<sup>17</sup> The current Belarusian legislation does not include a right of regress for guarantees.

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